

December 15, 2008

**Research Update:**

**ACA Financial Guaranty Corp.  
Ratings Raised To 'B'; Ratings Are  
Withdrawn**

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## Research Update:

# ACA Financial Guaranty Corp. Ratings Raised To 'B'; Ratings Are Withdrawn

## Rationale

On Dec. 15, 2008, Standard & Poor's Ratings Services raised its financial strength, financial enhancement, and issuer credit ratings on ACA Financial Guaranty Corp. to 'B' from 'CCC' and removed them from CreditWatch Developing. The outlook is developing. At the same time, we also withdrew the ratings at the company's request.

The upgrade reflects the positive effects of the restructuring transaction completed this past August that settled all outstanding CDO and reinsurance exposures of the company, including the significantly deteriorated CDO of ABS transactions, eliminating a requirement to post a significant amount of collateral to the CDO of ABS counterparties. The settlement required that ACA make a \$209 million cash payment and a distribution of surplus notes. The surplus notes provide the former CDO counterparties and certain other counterparties with what amounts to a 95% economic interest in the company.

As a result of the transaction, the company's \$7 billion risk portfolio is comprised almost exclusively of U.S. public finance exposure predominantly of 'BBB' and 'BB' credit quality with above-average concentrations in the health care and higher education sectors.

Statutory capital of \$174.7 million at Sept. 30, 2008, was down from \$414.8 million as of Dec. 31, 2007, reflecting in part the cost of the settlement. We assess ACA's capital adequacy as consistent with a speculative-grade rating, based on a margin of safety in the range of 0.5x-0.7x. The margin of safety expresses the relationship of theoretical losses incurred during a severe stress modeling exercise to capital remaining at the end of the modeling period.

The developing outlook reflects the following possibilities:

- That the company could run off in an orderly fashion with capital adequacy improving due to low losses and effective expense management; or
- That capital adequacy could deteriorate through a combination of meaningful losses precipitated by weak credits and/or a soft economy, poor expense management, and/or excessive distributions to surplus noteholders as allowed by the Maryland Insurance Administration (MIA).

There is also the risk that should finances deteriorate, ACA could be placed under rehabilitation by its regulator, the MIA, in which case the ratings would be changed to 'R'. An 'R' rating signifies that an insurer is under regulatory supervision because of its financial condition.

## Ratings List

ACA Financial Guaranty Corp.

Upgraded; CreditWatch/Outlook Action

	To	From
Counterparty Credit Rating		
Local Currency	B/Developing/--	CCC/Watch Dev/--
Financial Enhancement Rating		
Local Currency	B/--	CCC/Watch Dev/--
Financial Strength Rating		
Local Currency	B/Developing/--	CCC/Watch Dev/--

Ratings Withdrawn

	To	From
Counterparty Credit Rating		
Local Currency	NR	B/Developing/--
Financial Enhancement Rating		
Local Currency	NR	B/--
Financial Strength Rating		
Local Currency	NR	B/Developing/--

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